



Mol-affair: Foreign policy coup with potentially risky consequences

On May 24, Prime Minister Viktor Orbán unexpectedly, although not without preliminaries, announced: the government acquired the 21.2% stake of Russia's Surgutneftegaz in MOL for EUR 1.88 billion. While the acquisition is a foreign-policy success for the Hungarian state, it poses risks in domestic politics and may even undermine Mol's market position.

Background: prolonged stalemate

A few weeks before the Gyurcsány-Bajnai change of guard, in 2009 Surgut managed to acquire OMV shares above the market price after the Austrian oil company failed in its takeover bid for Mol. The Russian giant with murky shareholder background invested in the Hungarian company mainly to tap the company's strong regional position, production potential and its role played in the Nabucco-project, i.e., instead of short-term business objectives, it was motivated by long-term strategic thinking.

In 2009 Mol management successfully defended the company against the Russians, essentially resulting in a two-year stalemate: despite being the largest shareholder, Surgut failed to exercise its rights while it had no intention to exit either.

In the past two years there've been regular, primarily government-level discussions looking for a solution. Based on leaked information, the Bajnai-cabinet also planned to repurchase the Surgut stake, and following the change of government minister of national development, Tamás Fellegi has been the most active leading negotiations. The Orbán-government has declared its intention to increase state assets and consolidate strategic Hungarian companies.

Foreign policy coup carrying economic and political risks

The agreement is a foreign policy coup for the government as the Russians tried to secure Surgut's shareholder rights and the profit realised on the current transaction is not seen as genuine victory. At the diplomatic level the conclusion of the deal is all the more important because the impasse in the Mol affair got in the way of resolving other issues, such as the position of Malév, long-term gas delivery agreements and the expansion of the nuclear plant at Paks. While the current decision doesn't necessarily constitute part of a larger package, a settlement of the above issues cannot be neatly separated one from the other.

Since so far Surgut has been unable to influence Mol decisions, in theory the acquisition will have no immediate and direct effect on corporate strategy although, thanks to the transaction the Hungarian state became Mol's largest shareholder, not to mention that in connection to the nationalization of private pension funds the

package will increase by an additional 2.4%. As a result, the government will exceed the 25% business share and thus would have to make a purchase offer to other shareholders. However, in a more likely scenario, it will put some of its shares on the market. At the same time, the government's increased stake in the company also poses the risk that it will have a direct influence on management decisions, i.e., aside from business considerations, in the future Mol's strategy may reflect political thinking as well.

The transaction may also have an impact on Mol's Croatian subsidiary. Following reports of the agreement, the Croatian media presented the Hungarian government's action as something to emulate by the Croatian leadership, suggesting that strategically important INA should be protected along the lines applied by the Hungarian government in respect to Mol. Incidentally, following the upcoming elections in Croatia Mol can expect to face strong attacks as the likely winners, the Social Democrats plan to review a number of decisions passed since 2003 by succeeding cabinets led by the right-wing HDZ, even as the first privatization agreement with Mol had been signed by an earlier left-wing government.

According to a statement by Tamás Fellegi, the government finances the EUR 1.88 billion acquisition with unused tranches drawn from the IMF loan. Indeed, in theory the transaction does not affect the budget deficit or public debt, although this is only a question of accounting: the IMF loan will also have to be repaid in the coming years, i.e., the transaction is certain to slow the rate of public debt reduction.

Domestically, the takeover can be communicated to the public as a success story as the largest Hungarian company has been protected from the Russians, to this day far from popular in Hungary. At the same time, the opposition can exploit the affair in its attacks of the government:

- In the opposition camp, criticizing the government's spending cuts LMP and MSZP can set up the amount spent on the Mol buy-back scheme against the pain suffered by broad strata of society afflicted by the cuts.
- One year ago Fidesz had claimed time and time again that the previous governments had spent the entire IMF-loan, and now they admit financing the investment using the very same funds and discredit their own arguments promoting the need for austerity measures.
- In the past year the government has constantly emphasized the need to break away from the IMF, yet in this instance the latest effort in the direction of regaining independence is financed with a loan from the International Monetary Fund.

MOL in Croatia – Lull before the storm

The Mol-affair played a smaller-than-expected role in Croatia's election campaign: the government failed to put legal controls on the Hungarian Company's business share, which means that it will leave the resolution of the problem to the incoming administration. However, the temporary stalemate is but a lull before the storm; it is a foregone conclusion that following elections in Croatia Mol will have to put up a stiff fight to defend its business interests in the face bribery charges initiated by state prosecutors. Immediately after the inauguration of the new administration Mol's subsidiaries in Croatia are expected to become the target of political and legal attacks.

Ex-Lex INA

So far, the Mol-affair has been given a smaller-than-expected role in the Croatian election campaign. This is explained in part by the fact that there is no major difference of opinion between the two largest and strongest parties: both HDZ and SDP champion the protection of INA (the largest shareholder in the Croatian

national oil company, with Mol holding 47.16%). On the other hand, all major Croatian parties have become embroiled in Mol's real or imagined affairs in Croatia. The incumbent HDZ regularly rejects corruption charges levelled against the party claiming that when in power the Social Democratic SDP sold Mol a 25% stake in INA below a fair price. Moreover, the most important topic of the campaign is the issue of various large financial funds tied to HDZ, increasingly ensnaring the current prime minister, Jadranka Kosor. According to the charges, the government party financed its campaigns using funds of questionable origin channelled through these instruments. Indirectly Mol has been implicated in this affair when former Prime Minister, Ivo Sanader, defended himself by claiming that all surplus funds were channelled into this slush fund during his tenure, implying that all party leaders were in the know.

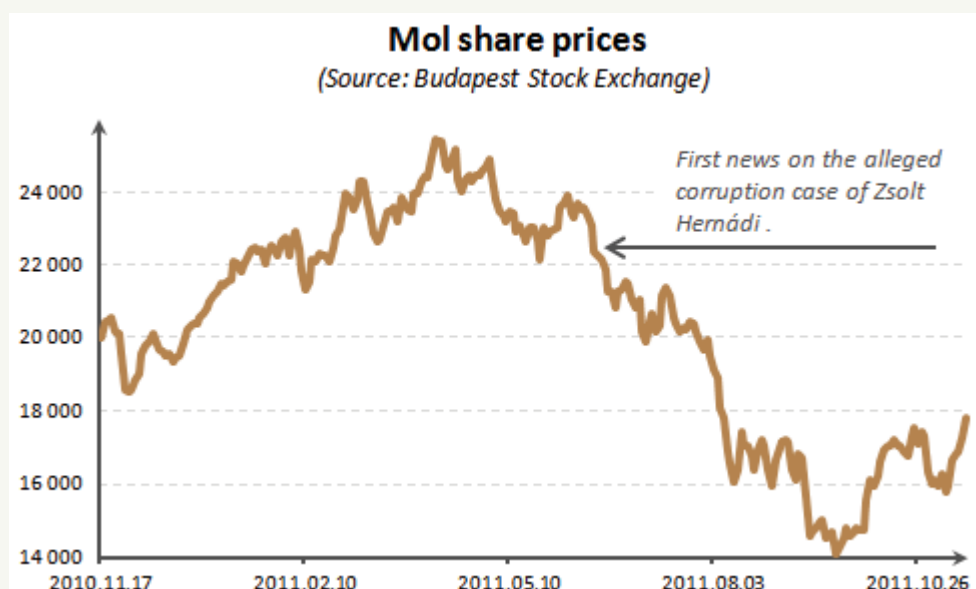
However, the current 'doldrums' is explained by the fact that a stalemate has developed in the Mol-INA face-off. As suggested in our previous prognosis, following the break of the alleged Mol-Sanader bribery scandal the HDZ-government aimed to introduce a bill to prevent non-state investors from acquiring a majority stake in INA. Should the bill pass, the government could easily claim to have defended the national oil company against foreign influence without driving away the Hungarian owner performing needed investments.

At the same time, as the country concluding accession talks in the summer did not wish to enter into a conflict with the EU it asked Brussels for advice. In turn, the EU took the firm position that such legislation would impede the free flow of capital and thus violate the principles of the European Union. With this the HDZ-led government lost its only tool it could have used to make some political hay out of the scandal. The Mol-INA affair is certain to be abandoned by the governing party is a symbol of its fight against the legacy of the Sanader-era and its corrupt practices. Consequently, in the past few weeks the party has noticeably neglected the whole affair and hopes to leave its resolution to the next administration.

Lull before the storm

Following the failure to pass an act aimed at regulating the ownership structure, for now HANFA (the Croatian financial supervisory) maintains a deadlock currently acceptable to all the political parties. Earlier this year Mol tried to acquire a majority in INA through a public offering. However, its attempt failed when Croatian pension funds and a "secret" foreign investor outbid Mol's offer. Soon after, HANFA blocked the trade of INA shares on the Zagreb stock exchange and initiated a probe against Mol's local managers on market-manipulation charges, claiming that Mol stood behind the foreign investors. This also carries risks for the Hungarian company because the Supervisory made specific reference to Zoltán Áldott, INA's top manager appointed by Mol, which means that, along with Mol president/CEO Mr. Hernádi, the company's second in command has also come under attack. The ban has been in effect for weeks and is expected to remain in place for quite some time. As Mol is unable to acquire a majority share in INA, the political parties in Croatia are under no pressure to take immediate action.

However, Mol cannot relax in respect to its position in Croatia: the scale of its expected losses due to be corruption scandal is yet to be seen. In the long term, acquiring 51% of INA would be the only satisfying solution for the company. For in this case even the cancellation of the 2009 agreement guaranteeing management rights would not leave the company with facing severe consequences. At the same time, due in part to the scandal every political party has committed itself to come to the rescue of INA. It is all too evident that any Croatian government will do everything in its power to prevent a Mol majority. Of course, the success of such a strategy is not guaranteed, and recent developments have increased the value of the company's 2009 agreement guaranteeing management rights even under current conditions. The same agreement may be seriously threatened by the bribery scandal.



In respect to the latter, developments appear to have accelerated. USKOK, Croatia's anti-corruption intelligence unit, is making a concerted effort to build its charges against Mr. Sanader on this case, which could serve as an important catalyst. However, to date all suspects in the case, including Mr. Sanader and his political associates, and Mol representatives have categorically denied the charges. In the meantime, less than conclusive evidence (although suitable for influencing public opinion) and more than bewildering "facts" are revealed day after day, such as a security camera video recording of a meeting between Sanader and Hernádi. Clearly, USKOK's repeated allegations alone are damaging to Mol, although the biggest risk is that the case could create a legal ground for cancelling the agreement guaranteeing management rights. Should the Hungarian company fail to defend itself against charges in Croatia, it will not only undermine the position of Zsolt Hernádi, but also threaten its joint venture in Croatia.

New government, business as usual

The effective settlement of the conflict is expected following the December election and in all likelihood Mol will have to reach a compromise with a government of a completely different composition. The odds have not significantly changed in the past few weeks; surveys predict a clear victory for SDP with a relatively large margin. According to forecasts prepared since August, HDZ may receive 19-20 percent of the votes, while 35-37 percent of the electorate is expected to line up behind the odds on favourite SDP, leader of the leftist 'Kukuriku' coalition. This will present a difficulty for the Hungarian company as in the past few years Fidesz has cultivated close ties with right-wing HDZ, not to mention that the new administration is unlikely to be as indebted to Hungary for its diplomatic assistance provided during Croatia's accession talks. The change of guard foreshadows difficult negotiations ahead.

The uncertainty is deepened by the fact that the opposition's position is not clear-cut on this issue. While SDP opposes Mol's efforts to acquire a majority stake in INA, in its current form it does not support the Lex INA either. For the most part the party emphasizes that the agreement guaranteeing Mol management rights must be amended, although it has no plans to review the company's share agreement. It promises that within 30 days following the change of government, the agreement will be harmonized with the Croatian legal system and the new government will cancel Mol's valuable gas contract whereby the Croatian state would take over the loss-making division.

As things stand today, it appears that Mol's Croatian subsidiaries may become the target of attack immediately after the inauguration of the new administration. According to a most likely scenario, on several levels the Hungarian company will lose its rights guaranteed by the 2009 agreement and will not be able to acquire a majority stake in INA. At the same time, as the Croatian oil company will need Mol's continued investments the Hungarian company will hold on to its current share package and, although with limited powers and under less favourable conditions, it will continue to exercise control over the Croatian oil company.